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California State Board of Equalization
450 N Street
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To: Members, State Board of Equalization

Subject: Methodologies for Valuing Independent Power Producers

We have two comments about the methodologies used to value unregulated, independent power producers.

Industry Background

The competitive landscape of the electric power industry has experienced significant change over the last three decades. Traditionally, the generation and sale of electric power had been the exclusive domain of regulated electric power utility companies. Such utilities operate as government sanctioned monopolies granting them the exclusive right to provide electric power to all retail electric power consumers in a defined geographic service region. They are subject to strict, government imposed, rate-regulation to ensure that retail consumers are charged fair and reasonable electricity price-rates despite the absence of competitive free-market based pricing. The rates are also regulated such that production costs can be covered and a reasonable rate of return on the investment can be guaranteed.

Changes in statutory and regulatory law have, by design, significantly altered the landscape of the electric power industry to permit and foster free-market competition and to bring about the rise of economic efficiencies. The passage and implementation of the Public Utilities Regulatory Policy Act of 1978, the Energy Policy Act of 1992, and Federal Energy Regulatory Commission ("FERC") Orders 888 and 889 issued in 1996, fostered the development of a new form of electric power industry participant, the Independent Power Producer ("IPP"), which, unlike traditional rate-regulated electric utilities, operate in an unregulated, competitive, free-market environment.

One significant consequence of IPPs operating in a competitive, free-market environment, is that like any industrial enterprise, they are exposed to the risks associated with often unpredictable changes in product supply and demand. Unlike traditional rate-regulated electric utilities that are guaranteed a return on their capital investment in all generation assets, and a return of their operating costs (which occurs through the rate regulation process), IPP's have no such guarantee. As a result, even IPP's which have Power Purchase Agreements with regulated utilities, are given no guarantee that they will either earn a market rate of return on their investment in generation assets or enjoy a recovery of their operating

costs. Any increase in capital investment or operating costs will significantly reduce a facility's rate of rate of return.

In electric power markets throughout the nation, and particularly in the Southwest region, including California, new generation capacity has come on-line in the past few years and created a significant oversupply of electricity. The predictable result of this overcapacity has been a decline in electricity prices at a time when electricity production costs have dramatically escalated along with natural-gas prices.

The electric utility industry as a whole faced many challenges in the last year. The ongoing crisis in the housing, financial, and credit markets that started in 2008 and plunged the overall economy into a massive downturn continues to affect the electric utility industry. In fact, analysts expect the performance of both the electric utility sector and the individual companies within the sector to remain relatively volatile over the next several years.

The electric utility industry will also be affected by the proposed restrictions on greenhouse gas (GHG) emissions. Current proposals would reduce GHG emissions to 1990 levels by 2020 and to 80% below 1990 levels by 2050. Additionally, renewable resources are to account for 30% of the federal government's energy use by 2020 and for 25% of total electric generation by 2025. Opposing the Renewable Portfolio Standard (RPS) mandate of the 2007 energy bill, the EEI argued that a mandate requiring 15% renewable generation by 2020 would require a three-fold increase above the 4.8% renewable generation that the Energy Information Administration (EIA) had projected by 2030, and that a mandate would require it 10 years earlier.

Valuation Methodologies

1. Currently the Board values these unregulated power plants using a Replacement Cost New less Depreciation model indicator of value, and a Capitalized Earnings Indicator. Various weightings are assigned to each of the value indicators based on the age of the facility and financial statistics. New plants are generally valued using 100% cost, and after an income stream is established, the Income Approach may be weighted. For a plant that has been operating for 5 or 6 years, and capitalized cash flows are less than the cost, after certain adjustments for obsolescence, the Indicators may weighted; 60% Cost and 40% Income. While in some cases this weighting may be acceptable, when the indicators are continually, significantly diverse, then a different weighting scheme must be utilized to reflect the strength or weakness of these Indicators of Value. When the Capitalized Earnings Approach is historically less than the Cost Approach, then maybe the Income Approach should be used exclusively.

2. The property of a non-renewable energy IPP is used for one purpose, to generate income. Market conditions, government mandates, the physical conditions of the property, and management all contribute to the ability to generate the amount of cash flow necessary to provide a return on and of the investment in the income-producing

assets. Notwithstanding the fact that an non-renewable IPP might derive some portion of its income from a Power Purchase Agreement, such properties are at a greater risk of being financially viable, especially with the California mandates for renewable energy. Consequently, the income/cash flow generated by an IPP and capitalized into value should be accorded more weight than the Replacement Cost model. A prospective purchaser would be more interested in the amount of current and future cash flows an income-producing property could generate, rather than what it would cost to replace the plant.

3. In the event that the Income Approach Indicator is significantly less than the Replacement Cost Indicator, staff must accord a greater weight, if not total weight to the Income Approach. This issue becomes even more important when recent history shows a trend of the Cost Approach far above the Income Approach.

4. While the Board calculates a specific Cost of Capital study for non-regulated independent power producers, a combination of regulated and the non-regulated rates are used when a significant portion of the assessee's income is derived from a Power Purchase Agreement, to reflect the reduction of risk in such properties. However, it is important to use the **unregulated rates exclusively** when only an insignificant portion, or no income is derived from a Power Purchase Agreement.

Conclusion

Notwithstanding the Board's desire for stability and predictability of property tax values for the non-regulated power producers, the Board-adopted values must reflect the specific circumstances of each assessee on an annual basis. It is the taxpayer's duty to provide staff with all factual data to value necessary to properly value their property, and it is the taxpayer's right to have their property properly valued based on their specific facts and appropriate appraisal theory.

Each year the staff values the unregulated power plants over 50 MW in the state of California. We request that the staff weight the calculated indicators of value to reflect more appropriately the actual factual operating statistics reported by the assessee. If the Income Approach is significantly less than the Cost Approach, then the Income Approach should be the primary, if not the sole indicator of value.

Regards,

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